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7 BEFORE THE INSURANCE COMMISSIONER
8 OF THE STATE OF WASHINGTON

9 In the Matter of the Application
10 regarding the Conversion and
11 Acquisition of Control of Premera Blue
12 Cross and its Affiliates.

No. G 02-45

PREMERA'S POST-HEARING BRIEF

13 **INTRODUCTION**

14 In accordance with the Commissioner's Twenty-Fifth Order: Order Extending
15 Case Schedule, PREMERA and Premera Blue Cross (collectively, "Premera") submit this
16 post-hearing brief. In the first part of its brief, Premera explains why the Amended Form
17 A satisfies the requirements of the Holding Company Acts and should be approved. The
18 brief next addresses the Commissioner's authority to impose conditions upon approval.
19 The brief then explains why Deputy Commissioner Odiorne's recommendation of denial
20 should not be followed, exposes flaws in the reasoning behind that recommendation, and
21 discusses the conditions that Mr. Odiorne has suggested be attached to any approval of
22 Premera's proposal. The brief concludes by exploring avenues to resolve the few items
23 that, according to representatives of The Blackstone Group, are all that stand in the way of
24 their giving an opinion (if required) that the transaction, taken as a whole, is fair from a
25 financial point of view.

ARGUMENT

A. The evidence in this case requires approval of Premera's Amended Form A.

Premera's Hearing Brief (April 23, 2004) addresses in detail the legal standards that govern this proceeding and explains why the evidence requires approval of Premera's Amended Form A. *See id.*, pages 30-48. The evidence at hearing confirms what Premera said in its Hearing Brief: Premera meets all of the tests set forth in the Holding Company Acts, RCW chs. 48.31B and 48.31C, for approval of its Amended Form A. Specifically, Premera satisfies the requirements for registration as a health carrier¹; the conversion will not substantially lessen competition or tend to create a monopoly in the health coverage business²; the transaction will strengthen Premera's financial condition³; the proposed conversion is fair and reasonable to Premera's subscribers and in the public interest⁴; Premera's Board and management team exemplify competence, experience, and integrity⁵; and the conversion is not likely to be hazardous or prejudicial to the insurance-buying public.⁶ Those who oppose conversion have not met their burden of establishing a basis for disapproval. *See* Hearing Brief, pp. 32-33.

¹ Hearing Brief, p. 33; *accord* RP 2069 (Cantilo), 2425 (Odiorne).

² Hearing Brief, pp. 33-35; *accord* RP 515 (McCarthy), 1778 (Leffler). Mr. Odiorne speculated that there might have been some change in the market after Dr. Leffler's study, but there is no evidence of such change, much less substantial evidence of antitrust injury in this case. *Compare* RP 2426 ("there is a chance that there could be some competitive harm.") (Odiorne) with Exhibit S-33 (Exec. Summ.), p. 9 ("it is improbable that the [conversion] will violate antitrust laws") (Cantilo).

³ Hearing Brief, p. 36; *accord* RP 883, 981-92 (Kinlead), 1361 & 1384-87 (Koplovitz), 1507-08 (Alderson Smith), 2073 (Cantilo). Mr. Odiorne's views on this subject are discussed in Part C.1. below.

⁴ Hearing Brief, pp. 36-45; *accord* RP 119-22 (Barlow), 1120 (Marquardt). *See also* RP 300-01 (Reid), 1563-64 (Lundy). The many flaws in the economic impact analysis and model produced by the PwC consultants are discussed in Exhibit A to this brief.

⁵ Hearing Brief, pp. 45-47; *accord* RP 90 (Jewell), 1217 (Fox), 1389 (Koplovitz), 2076-77 (Cantilo).

⁶ Hearing Brief, pp. 47-48; *accord* RP 139-40 (Barlow), 548-49 (McCarthy), 650 (Lusk), 2077-78 (Cantilo). *See* Exhibit A for a discussion of the economic impact analysis performed by PwC.

1 The Administrative Procedure Act requires that the Commissioner's decision
2 include findings and conclusions "on all the material issues of fact, law, or discretion
3 presented on the record" RCW 34.05.461(3). Findings of fact must be based
4 "exclusively on the evidence of record in the adjudicative proceeding and on matters
5 officially noticed in that proceeding." RCW 34.05.461(4). Based upon the testimony
6 given at the hearing and other evidence in the record, Premera has prepared proposed
7 findings of fact and conclusions of law, which are filed herewith. Each proposed finding
8 includes citations to the record that reflect testimonial and other evidentiary support for
9 that finding.⁷

10 **B. The Commissioner's authority to impose conditions upon approval rests upon**
11 **the standards in the Holding Company Acts.**

12 The Holding Company Acts set forth specific standards by which a Form A
13 transaction—that is, a proposed acquisition of control—is to be judged. These standards
14 not only establish the specific grounds for disapproval of a Form A; they also provide the
15 authority pursuant to which the Commissioner may condition his approval.

16 The Holding Company Act for Health Care Service Contractors establishes, in two
17 separate provisions, that the Commissioner's authority to condition his approval requires a
18 predicate finding that, absent the condition, the proposal would be subject to disapproval
19 under that statute's standards. Conditions that are imposed must also address the basis for
20 disapproval. RCW 48.31C.030(5)(a)(ii)(C) provides:

21 (C) The commissioner may condition the approval of the acquisition on
22 the removal of the basis of disapproval, as follows, within a specified
23 period of time:

24 RCW 48.31C.030(5)(c) provides, similarly:

25 (c) The commissioner may condition approval of an acquisition on the
removal of the basis of disapproval within a specified period of time.

⁷ By proposing findings of fact on certain matters that were the subject of testimony at the adjudicative hearing, Premera does not concede that such matters are relevant to the Holding Company Act standards for judging the conversion proposal.

1 If there is no basis to disapprove Premera's Amended Form A under the standards
2 set forth in the Holding Company Acts, then there is no basis to impose conditions upon
3 approval. The OIC Staff has ignored this principle, proposing conditions that have no
4 connection with the standards set forth in the Holding Company Acts. The Holding
5 Company Acts focus on the interests of Premera's subscribers and the insurance-buying
6 public. Proposed conditions that threaten Premera's ability to retain its license to use the
7 Blue marks, or that undermine the ability of the New PREMERA Board to direct the
8 affairs of the company, are directly contrary to those interests.

9 **C. The OIC Staff's recommendation is unwarranted.**

10 Far from reflecting the evidence introduced at the adjudicative hearing, Mr.
11 Odiorne's recommendation that the Commissioner disapprove Premera's Amended Form
12 A rests upon factors that any objective observer would conclude strongly favor
13 conversion. It flies in the face of the findings of the OIC Staff's own consultants. It
14 cannot be squared with the language or the goals of the Holding Company Acts. It
15 reflects, and invites, legal error at multiple levels. It should not be followed by the
16 Commissioner.

17 **1. Financial strength**

18 According to Mr. Odiorne, the first reason to disapprove the conversion is its
19 impact upon Premera's financial stability. Premera is capital constrained, he said;
20 Premera could lose the benefit of a federal tax deduction offered under Section 833(b);
21 and the economic assurances negotiated by the OIC Staff's consultants "could adversely
22 impact the financial condition of Premera[.]" RP 2372. Mr. Odiorne was apparently
23 oblivious to the unanimous testimony at the hearing that Premera's conversion is intended
24 to, and will, strengthen its capital position. RP 77-78 (Jewell), 111-12 & 116 (Barlow),
25 460 & 467-68 (Novak), 1120 & 1125 (Marquardt), 1218-19 (Fox), 1385-87 (Koplovitz),
1507-08 (Alderson Smith), 2073 (Cantilo not aware of any evidence that the financial

1 condition of New PREMIERA might jeopardize Premera's financial stability or prejudice
2 the interests of its subscribers). It is hard to imagine overlooking the positive impact of
3 adding tens of millions of dollars to Premera's capital reserves, plus gaining the flexibility
4 to access the capital markets in the future, but Mr. Odiorne managed to do so.⁸

5 According to Mr. Odiorne, a potential change in Premera's marginal tax rate
6 "would result in several hundred million dollars of additional taxes." RP 2413. This is an
7 absurd overstatement.⁹ He also suggested that the economic assurances would harm
8 Premera financially, but he did not attempt to calculate the amount of such harm relative
9 to the capital infusion Premera expects to receive through an IPO. RP 2416.¹⁰

10 2. Uses of capital

11 Mr. Odiorne next claimed that the Amended Form A is deficient because it fails to
12 spell out how Premera will spend the capital that it hopes to raise. Mr. Odiorne failed to
13 heed oft-repeated testimony describing what Premera would do with such capital: bolster
14 its reserves, support membership growth, and invest in infrastructure, product, and service
15 improvements. In particular, he ignored the first reason for Premera's proposal. As Mr.
16 Barlow and others explained, additional capital does not have to be spent, and certainly
17 not spent immediately. It serves the purpose of increasing Premera's RBC and

18 ⁸ Asked whether he considered anything that might be favorable to Premera's economic
19 stability in doing his analysis, Mr. Odiorne stated: "It was part of what I heard and I can't
say that I specifically laid them all out side by side." RP 2416-17.

20 ⁹ Premera's net income in 2003 was less than \$50 million. A 15% increase in the
21 marginal tax rate, if (contrary to fact) it were effective in 2003 rather than 2007 at the
22 earliest, would result in some \$7.5 million in additional taxes. Mr. Ashley testified,
23 moreover, that this is an unsettled area of tax law; Premera has substantial arguments to
24 support its position that it should be able to retain the deduction; and the outcome of that
question may not be known for many years. RP 1539. Moreover, even though they
assumed (as a worst-case scenario) that the deduction would be lost, the investment
bankers opined that Premera would be an attractive investment. RP 1546 (Ashley), 1388-
89 (Koplovitz).

25 ¹⁰ Mr. Odiorne criticized the assurances in the Amended Form A notwithstanding that the
consultants he hired and supervised proposed such assurances and agreed to their form.
See Exhibit P-222; RP 2415-16. The OIC Staff echoed that criticism in closing argument
but then, in the next breath, endorsed extension of the assurances if the Commissioner
decides to approve the conversion with conditions. RP 2546.

1 strengthening its financial position simply by being available to meet subscriber
2 obligations and to support growth. RP 115-19 (Barlow), 1120 (Marquardt).

3 Several witnesses also testified that it was premature to earmark capital yet to be
4 raised, particularly when the amount of such capital remains uncertain. RP 2471-72
5 (Barlow), 986 (Smit), 1148-49 (Marquardt). As Mr. Odiorne acknowledged during cross-
6 examination, Premera will apply for a solicitation permit near the time of the IPO. RP
7 2420. This will reflect the language in the prospectus about uses of capital. In the
8 meantime, Mr. Odiorne himself bears substantial responsibility for this straw man
9 “deficiency,” for he directed Blackstone not to consider how Premera might invest its
10 newly raised capital. *See* Exhibit P-111, pp. 380-81. (Mr. Odiorne now says that he does
11 not remember giving this direction. *See* RP 2407.)

12 Apart from these flaws in his analysis, Mr. Odiorne’s claim comes too late. He did
13 not identify any deficiency associated with proposed uses of capital during the lengthy
14 examination of the company, including during his meetings with Premera’s management.
15 The OIC Staff also did not mention this issue in response to Judge Casey’s order last
16 September, when the OIC Staff was directed to identify any deficiencies in Premera’s
17 Form A Statement, or in subsequent hearings before the Commissioner.¹¹ Mr. Odiorne’s
18 claim that the Form A “is deficient” simply cannot be credited. *See* RP 2420-22.

19 3. Board continuity

20 Mr. Odiorne also referred to “management entrenchment” as a concern. This
21 phrase comes from Mr. Cantilo, and no one else. RP 2422. It is a pejorative term for
22 which there is no basis in the record.¹² As Mr. Barlow explained, conversion to a public

23 ¹¹ *See* Insurance Commissioner’s Memorandum Regarding Deficiencies in Premera’s
24 Form A Statement (Sept. 12, 2003).

25 ¹² The notion of “management entrenchment” appears to have sprung from Mr. Cantilo’s
examination of the due diligence conducted by the Premera Board and, in particular, its
consideration of a potential merger or sale of the company. That issue, together with the
related question raised by the Commissioner about the potential acquisition of a for-profit
Premera, is addressed in Exhibit B to this post-hearing brief.

1 company will produce greater uncertainty, not less, regarding the tenure of the company's
2 directors and executives. RP 2473.¹³ These days, boards of publicly traded companies
3 operate under intense scrutiny, and management must be accountable for its performance.
4 Beyond these forces, Mr. Odiorne ignored the proposed addition to the Premera Board of
5 two Designated Members, nominated by the foundations. They will play key roles in the
6 governance of the company after conversion. Mr. Odiorne's assertion that maintaining
7 local control is paramount to Premera is equally without merit. As Mr. Barlow explained,
8 local control is a means to an end—namely, delivering on Premera's mission to its
9 members—and not an end in itself. RP 2474, 2519.

10 Perhaps Mr. Odiorne meant to attack the BCBSA requirement that the Board
11 remain in place following conversion. But such continuity is surely desirable from the
12 standpoint of protecting Premera's subscribers, as well as enhancing the value of its stock.
13 Perhaps he was casting aspersions about motivations. But Sally Jewell was emphatic in
14 dismissing such charges:

15 I am very sensitive to the issue of executive compensation and if I thought
16 for a minute that there was any personal motivation on the part of the
17 executives here, I would not support it. That is absolutely not part of our
18 motivation whatsoever.

19 RP 81. Mr. Cantilo had to agree: in the end, he had no basis to question the integrity of
20 Premera's Board and management. *See* Exhibit S-33, p. 60; RP 2076-77. Whatever else
21 might be said on the subject of Mr. Odiorne's innuendo about "entrenchment," it cannot
22 support disapproval of Premera's proposal.

23 4. The role of the BCBSA

24 Mr. Odiorne said that he was troubled by the fact that the BCBSA has not yet
25 approved Premera's proposal. This statement reflects misunderstanding of the BCBSA's
role. The Association does not purport to tell the Commissioner what to do. It evaluates a

¹³ Currently the Premera Board of Directors is self-perpetuating, as is commonplace among nonprofit corporations. Nonprofit boards could be said to be truly "entrenched," which makes Mr. Odiorne's observation paradoxical at best.

1 proposed conversion (including any conditions attached to approval) for the purpose of
2 determining whether the terms are consistent with maintaining the plan's BCBSA license.
3 RP 127-28 (Barlow); Exhibit P-4, p. 17. Mr. Odiorne has no good-faith basis to claim
4 ignorance of the terms that would be acceptable to the BCBSA, for they have been spelled
5 out in the evidence and in the WellChoice transaction and discussed at length by the OIC
6 Staff's consultants. *See id.*, Exhibit B; Exhibit P-81.

7 For reasons known only to himself, Mr. Odiorne chose to ignore his investment
8 banking consultants and to endorse instead Mr. Cantilo's agenda of pursuing a showdown
9 with the BCBSA. Mr. Odiorne evidently wants to "push the envelope" by seeking
10 concessions from the BCBSA that have never been granted in any prior conversion.
11 Jeopardizing Premera's right to use the Blue marks can hardly be thought to be consistent
12 with protecting its subscribers or the insurance-buying public. Losing the marks would
13 also have potentially disastrous effects on the value to be realized by the foundations.¹⁴

14 **5. Fair market value**

15 Ironically, Mr. Odiorne next cited lack of "fair market value" to the foundations as
16 a basis for recommending disapproval of the conversion. He offered no support for the
17 implicit proposition that fair market value must be transferred, other than "[m]y concept
18 of transferring assets or stock is a transfer of the full value of the company at that point."
19 RP 2374. Mr. Odiorne's "concept" does not reflect the requirements of Washington law.
20 *See* RP 2455-58 (Steel).¹⁵ His sense of what has real value is equally suspect. Asked

21 _____
22 ¹⁴ Mr. Odiorne should have been leery of Mr. Cantilo's advocacy on this issue. To be
23 sure, Mr. Cantilo in his direct testimony disputed that he had acted as an advocate,
24 denying (among other things) that he had "written any briefs." RP 2044. His statement
25 was false. *See* Exhibit P-110, p. 142 (discussing briefs prepared by Mr. Cantilo that were
intended to negate Premera's claims of privilege and work product); Exhibit P-111, pp.
419-20, 421-22 ("there were many times when in the context of filings either for the
attorney/client privilege issues ... or some other proceeding we may have assisted Mr.
Hamje with either language or legal analysis ..."; "we were certainly assisting Mr.
Hamje in that advocacy").

¹⁵ The term "fair market value" does not appear in any statute applicable to Premera's
Form A application. *See* RP 2456 (Steel). Mr. Odiorne, like Mr. Cantilo, apparently

1 whether he agreed that protection of the Blue marks is of substantial value to Premera's
2 subscribers and to the insurance-buying public, Mr. Odiorne testified: "I'm not sure of the
3 value. Some value." RP 2430. He expressed willingness to put that value at risk for the
4 sake of enhancing the foundations' voting rights. RP 2374-75, 2431-32. If these voting
5 rights have any value, it cannot, according to the OIC Staff's investment banking
6 consultants, even be measured. RP 1484 (Alderson Smith). As they testified, the value of
7 the rights sought by Mr. Odiorne pales in comparison to the impact of losing the Blue
8 marks. Exhibit P-103, pp. 155-56.¹⁶

9 **6. Subscriber interests**

10 Mr. Odiorne next addressed the interests of Washington subscribers.¹⁷ He ignored
11 completely the potential harm to those subscribers if Premera were to lose its BCBSA
12 license, which should have been of paramount concern. Instead, he focused on two issues:
13 first, the desirability of providing equal guarantees to Washington and Alaska subscribers,
14 and second, the possibility that Premera might upgrade its computer system and thereafter
15 charge different rates in Eastern Washington. These issues are makeweights.

16 As Mr. Marquardt testified, Premera accepts the proposition that the guarantees to
17 the Alaska and Washington subsidiaries should both address replacement coverage. Mr.
18 Cantilo acknowledged that a condition requiring a guarantee of replacement coverage as
19 well as claims coverage in both states would satisfy his concern—and, indeed, would fully
20 resolve any and all issues involving Premera's proposed Form D transactions. RP 2079-

21 lifted the phrase from the Acquisition of Nonprofit Hospitals Act, RCW 70.45.070(5)
22 ("The nonprofit corporation will receive fair market value for its assets. The attorney
23 general or the department [of health] may employ ... reasonably necessary expert
24 assistance in making this determination.").

25 ¹⁶ Mr. Odiorne also testified that "Premera is insisting that two separate owners," that is,
the two foundations, must share a single 5% bloc of shares. RP 2375. He later admitted
that was a misstatement. RP 2432-33.

¹⁷ In passing, Mr. Odiorne expressed concern about the requirement in the Unallocated
Shares Escrow Agreement that the foundations participate in the IPO to the extent of 10%
of their initial share holdings. Premera is willing to accept a condition removing that
requirement from the Unallocated Shares Escrow Agreement. See Exhibit C.

1 80. Particularly given this testimony and the fact that there is no disagreement about the
2 appropriate resolution of the question, the guarantee issue cannot serve as a basis for
3 disapproval.

4 Equally meritless is Mr. Odiorne's speculation about the uses to which a new
5 computer system might be put.¹⁸ He was evidently unaware of the fact that, if Premera
6 could charge different rates for individual and small-group products using geographic
7 factors, premium rates in Eastern Washington would drop rather than rise. RP 2436-37;
8 *see* Exhibit A, p. 5 n.3. In any case, Mr. Odiorne expressed uneasiness about the
9 economic assurances that had been drafted by his consultants to address rate concerns,
10 because of the supposed adverse impact of such assurances on Premera's financial
11 standing. He thereby transformed the economic assurances—a positive feature of the
12 Amended Form A, according to the OIC Staff's consultants—into a Catch-22.

13 7. Insurance-buying public

14 As the last basis for his recommendation, Mr. Odiorne mentioned the insurance-
15 buying public. He testified:

16 Premera will rely on growth in overall revenue, growth in membership.
17 Focus on those two areas is a stock market shareholder focus, rather than
an insurance-buying public focus.

18 RP 2378. Insofar as this testimony is based upon the supposition that Premera can satisfy
19 its shareholders at the expense of the insurance-buying public, it is fundamentally
20 mistaken. *See* RP 82 (Jewell), 132-33 (Barlow), 882 (Kinhead). Premera will satisfy
21 shareholders only if it continues to focus upon serving the insurance-buying public. As
22 Dr. McCarthy testified:

23 the shareholders of for-profit companies care very much that their company
24 does a good job, that the quality is good and that prices are good, because
otherwise there will be no revenues. They will sell nothing. They will
25 have no profits because nobody is interested in their product.

¹⁸ Mr. Odiorne's discovery of this potential use for new capital funds is directly contrary to his testimony about the supposed "deficiency" in Premera's Amended Form A.

1 RP 628-29.

2 Mr. Odiorne also misses the boat in another sense: Premera plans to grow its
3 revenue and its membership whether it remains a nonprofit or becomes a for-profit
4 corporation. RP 1147-48 & 1154 (Marquardt). Conversion will enable Premera to bring
5 enhanced products and services to more of the insurance-buying public and to achieve
6 greater per-member administrative cost savings. RP 119 (Barlow); 1155-58 (Marquardt).
7 Therefore, this factor favors the conversion proposal. And even if one were to credit Mr.
8 Odiorne's claim that Premera has exited unprofitable lines of business in anticipation of
9 conversion (despite Mr. Barlow's and Mr. Marquardt's unequivocal testimony to the
10 contrary, and despite numerous examples of similar actions taken by other nonprofit
11 insurers), that would not constitute a reason to deny conversion. Premera will not re-enter
12 unprofitable lines of business, even if its corporate structure remains unchanged.

13 In short, Mr. Odiorne's stated rationale for his recommendation does not withstand
14 scrutiny and cannot support disapproval of Premera's proposal. On the contrary, any fair
15 evaluation of the evidence would compel a favorable recommendation.

16 **D. Although some of the OIC Staff's proposed conditions are reasonable, others**
17 **are both insupportable and destructive.**

18 The OIC Staff's recommendation included a list of conditions that should be
19 attached to the Commissioner's approval of Premera's proposal, if granted. Some of these
20 conditions were reiterated, in modified form, in the OIC Staff's closing argument.¹⁹
21 Attached as Exhibit B is a table listing the OIC Staff's recommended conditions and
22 Premera's response to each of them.
23

24 ¹⁹ The OIC Staff also suggested in closing argument that the Commissioner require, as a
25 condition of approval, a specific allocation of the stock between the Washington and
Alaska foundations. The question of allocation cannot be resolved by a condition
imposed upon Premera; rather, it must be settled between the states. Nor need that
question be resolved before the closing of the conversion transaction. Any shares that
remain in dispute will be handled under the Unallocated Shares Escrow Agent Agreement.

1 Among the conditions that Premera is willing to accept is one that prevents any
2 federal tax liability associated with potential loss of the Section 833(b) deduction as a
3 result of the conversion from being passed on to policyholders. This means that the risk
4 of losing the deduction will be borne entirely by Premera's shareholders. Hence, even if
5 the Commissioner believed that the risk of losing the deduction could be material to
6 subscribers and the insurance-buying public, the condition suffices to remove Section
7 833(b) as a basis for disapproving the transaction. Premera is also willing to have the
8 Unallocated Share Escrow Agent Agreement reformed to eliminate the requirement of a
9 10% required sale at the IPO.²⁰

10 On the other hand, Premera cannot accept proposed conditions that would result in
11 a forfeiture of its BCBSA license.²¹ What is remarkable about the concessions demanded
12 in these proposed conditions is that, by the OIC Staff's consultants' own testimony, they
13 are small issues that go beyond the terms of the WellChoice conversion and every other
14 precedent transaction (RP 1397-99, 1491-92); they will have no impact on the amount that
15 investors would be willing to pay for the foundations' shares (RP 1485); and their value to
16 the foundations, if any, cannot be quantified (RP 1484). By contrast, loss of the Blue
17 marks would result in a "strong negative quantitative loss of value" to the foundations (RP
18 1484). *Accord* RP 879-80 (Kinhead).

19 While any objective consideration of relative value would show these conditions to
20 be misguided, the OIC Staff's insistence upon them is all the more perplexing because (a)
21 they are wholly unrelated to the interests of subscribers and the insurance-buying public,
22 and (b) the law affords no basis to impose such conditions. As Mr. Alderson Smith
23 testified, Blackstone's analysis of the transaction terms in the Amended Form A did not

24 _____
25 ²⁰ With respect to these and other conditions that it is willing to accept, Premera does not
concede that there is a basis to impose such conditions under the Holding Company Acts,
nor does it waive its objections to other conditions that lack a basis in those Acts.

²¹ These five conditions were discussed by Kent Marquardt, RP 1131-33, and they appear
on the first two pages of the copy of Exhibit P-94 that was distributed at the hearing.

1 consider the potential impact of the transaction upon subscribers and the insurance-buying
2 public. He acknowledged that the interests of such persons were important and that, if one
3 viewed the few transaction terms that remain in dispute from the perspective of
4 subscribers, “[t]here may be some difference in emphasis.” RP 1489. Indeed, focusing
5 upon subscribers—as the Holding Company Act requires—mandates rejection of all
6 conditions that threaten Premera’s continued ability to use the Blue marks, given the
7 extraordinarily deleterious effects of such a loss upon Premera’s members.

8 Like Mr. Alderson Smith, Mr. Cantilo made clear that his objections to the
9 transaction terms were grounded upon the supposed obligation to deliver Premera’s “fair
10 market value” to the two foundations. RP 2040. Insofar as he had concerns about the
11 potential impact on Premera’s subscribers and the insurance-buying public, those concerns
12 were ones “about which we were informed by the other OIC consultants and about which
13 you have already had comprehensive testimony, primarily by PricewaterhouseCoopers
14 and by Dr. Leffler.” RP 2041.²²

15 Mr. Alderson Smith testified that his analysis of fairness was based upon the
16 unsubstantiated legal assumption that Premera is owned by the public. RP 1487. That
17 assumption is contrary to Washington law. RP 1261 (Steel); *see* RP 1150 (Marquardt).
18 As Mr. Alderson Smith admitted, if the assumption that the public owns Premera is not
19 indulged, then there is no basis to conclude that the proposed transaction is “unfair.” RP
20 1488. By the same token, there is no basis to insist upon terms thought to make the
21 proposal more “fair.” Similarly, Mr. Cantilo admitted that, if Premera has no obligation
22 under Washington law to transfer its “fair market value”—and Mr. Steel testified at RP
23 2455-58 that there is no such obligation—then Mr. Cantilo’s “criticisms of the impact of
24 stock restrictions in reducing the value of the assets transferred would on that ground be
25 inapplicable.” Exhibit P-113, p. 288.

²² The PwC economic analysis and model are discussed in Exhibit A.

1 These admissions explain the Herculean efforts of the OIC Staff and consultants to
2 find some ground upon which to insist that Premera has a legal obligation to transfer more
3 than it has committed to transfer to the foundations—namely, 100% of the initial stock in
4 New PREMERA, subject to the restrictions set forth in the Amended Form A.²³ For
5 example, Mr. Cantilo at the hearing purported to find support in the Nonprofit Corporation
6 Act and Premera's articles of incorporation for his assumption that Premera must convey
7 "fair market value"; he dismissed his earlier charitable trust analysis as incidental. RP
8 2047-49, 2084-85, 2124. In deposition, by contrast, Mr. Cantilo testified that nothing
9 other than his assumption that the public owns Premera's assets informed his judgment
10 that Premera has a fundamental legal obligation to transfer the fair value of its assets to
11 the foundation shareholder. Exhibit P-110, p. 96; *see id.*, pp. 213-14 (Mr. Cantilo
12 assumed Premera's "seller" to be the people of Washington and Alaska); Exhibit P-112,
13 pp. 68, 83, 147-48.

14 Even more striking, Mr. Cantilo testified at deposition that his assumption was
15 based upon instructions received from the OIC Staff, and it reflected no legal analysis
16 whatever. Exhibit P-112, p. 57; Exhibit P-113, pp. 280-83. He was unaware of any
17 statutory obligation on the part of Premera to dedicate its assets to benefit the public.
18 Exhibit P-112, p. 12. And he never mentioned Premera's articles of incorporation as a
19 source of such an obligation.²⁴ *See also* RP 2454-58 (Steel).²⁵ The record in this case

20 ²³ If there is no legal requirement specifying what must be transferred, Mr. Cantilo
21 admitted, then there is no basis to say that restrictions upon the foundations reduce the
22 required value or are otherwise impermissible. Exhibit P-113, p. 282.

23 ²⁴ None of Mr. Cantilo's reports (Exhibits S-31, S-32, S-33, S-34, and S-35) mention
24 Premera's articles of incorporation as a source of its supposed obligation to transfer fair
25 market value. Communications within Cantilo & Bennett (e.g., Exhibits P-116, P-132,
and P-145) and between Cantilo & Bennett lawyers and Washington officials (e.g.,
Exhibits P-118, P-119, P-122, P-123, P-134, P-139, and P-140) also say nothing about
Premera's supposed obligations under its current articles of incorporation, other than as
they might or might not support some kind of charitable obligation.

²⁵ Article XII of the Articles of Amendment of the Articles of Incorporation of Premera
(Exhibit A-2 to the Amended Form A [Hearing Exhibit C-2]) provides that the distribution
of the assets of the corporation upon dissolution "**shall be subject to the limitations of**

1 shows that Mr. Cantilo developed the theory he espoused at the hearing in a last-ditch
2 effort to salvage the fundamental assumption underlying his analysis, which had been
3 exposed as baseless.

4 In reality, there is no obligation such as that assumed, and then asserted, by Mr.
5 Cantilo.²⁶ As John Steel testified, the stock in a going concern necessarily comes with
6 restrictions borne of the company's contractual obligations, which in this case includes
7 Premera's Blue Cross Blue Shield license. RP 2456-57. The transfer of stock with such
8 restrictions, Mr. Steel testified, satisfies any obligation that Premera might (wrongly) be
9 assumed to have to convey "fair market value." RP 2461-62, 2468-70.²⁷ Of course,
10 others may disagree. But that disagreement is immaterial here, since the fundamental
11 point is that conditions proposed by the OIC Staff lack any legal basis.²⁸

12 applicable law ... and **any contractual obligations associated with the Foundations'**
13 **receipt of such proceeds.**" (Emphasis added.)

14 ²⁶ Nor was there any agreement by Premera that it intended to convey, or was required to
15 convey, "fair market value." Of course, even if Premera had said that it was going to
16 transfer the fair value of its assets, that would not establish a legal obligation on Premera's
17 part to do so—despite Mr. Cantilo's efforts to suggest otherwise. Here, too, Mr. Cantilo's
18 testimony was transformed at the hearing. Compare RP 2047 ("company clearly has told
19 anyone who will listen that it's going to convey 100 percent of its market value") with
20 Exhibit P-112, p. 27 (Premera has never stated either publicly or privately to Mr. Cantilo
21 or in his presence that its value must be paid as part of the conversion). See also RP 2046
22 (consultants sought confirmation in February 2003 that Premera intended to convey "fair
23 market value"; Premera declined); RP 2458-61 (discussing absence of any "agreement" as
24 alleged by Mr. Cantilo).

25 ²⁷ In reality, the value of the stock will be established by the market after Premera's IPO.
RP 102 (Jewell), 140-41 (Barlow), 879 (Kinhead), 1151 (Marquardt), 1480 (Alderson
Smith).

²⁸ The only conditions relating to the proposed transfer of stock to the foundations that
may properly be imposed in this proceeding are those agreed upon by Premera. As
Exhibit C reflects, Premera has agreed to several such conditions. Moreover, although
Mr. Odiorne neglected to mention them, there are three additional conditions that appear
appropriate in light of the evidence. First, to resolve the sole remaining issue involving
the Form D transactions that were evaluated by the OIC Staff's consultants (Tillett and
Cantilo), it would be appropriate to require that the terms of the guaranty provided to New
Premera Blue Cross with respect to continuation of coverage be identical to those of the
guaranty provided to New Premera Blue Cross-Alaska. See RP 1141-42 (Marquardt),
2041-42 & 2079-80 (Cantilo). Second, the technical corrections described in Exhibit P-59
[a/k/a Exhibit A to the Pre-Filed Direct Testimony of Kent Marquardt] should be deemed
to be reflected in the documents in the Amended Form A. And third, the references to
"twelve (12) months" in Section 4.03(c) and 4.03(e) of the Voting Trust and Divestiture

1 **E. As Blackstone representatives testified, the few remaining issues that they**
2 **identified can be readily resolved.**

3 At the conclusion of Mr. Alderson Smith's testimony, the Commissioner asked
4 whether there were particular factors among the unresolved transaction terms that, in
5 Blackstone's view, were more important from the Foundation's standpoint than others.
6 RP 1515. Mr. Alderson Smith identified two: the standard for independence of New
7 PREMERA directors, and the right to nominate directors to the New PREMERA board.
8 RP 1515-16. As to those factors and others discussed in his testimony, Mr. Alderson
9 Smith made clear that he saw avenues of compromise that could resolve his and the other
10 parties' fairness concerns. He suggested, for example, that the test for director
11 independence set forth in the bylaws of New PREMERA [Exhibit B-2 to the Amended
12 Form A, which is Hearing Exhibit C-2] could be revised to maximize the independence of
13 those directors and yet not harm Premera. RP 1517. Similarly, he testified that concerns
14 about a combined divestiture schedule would be allayed if the cross-default provisions
15 were eliminated. RP 1501-02; *accord* RP 2109-10 (Cantilo).

16 Mr. Alderson Smith also recommended that the voting trust and divestiture
17 agreement be modified, not scrapped, if Premera loses its BCBSA license. RP 1502-03.
18 Specifically, he testified that it would be advantageous to retain some limitations upon the
19 foundations' governance rights, while setting aside the divestiture schedule so that the
20 foundations were not selling into a depressed market. RP 1504-05.

21 Consistent with its record of seeking to address and resolve the concerns of the
22 OIC Staff's consultants so long as doing so would not threaten its BCBSA license or
23 otherwise jeopardize its continued ability to serve its members, Premera has drafted
24 language that follows Mr. Alderson Smith's recommendations and seems likely to resolve
25 any lingering concerns. The draft proposals are attached as Exhibit D.

Agreements (as amended by the technical corrections described above) should be changed
to "six (6) months." See Exhibit P-58, p. 27; Exhibit S-44, ¶ 5.

1 CONCLUSION

2 Premera's Amended Form A should be approved. If and to the extent that the
3 Commissioner considers imposing conditions upon his approval, Premera repeats the
4 request made by Mr. Milo in closing argument, RP 2538, that the Commissioner afford
5 the parties an opportunity to review and comment on any proposed conditions before
6 rendering his decision.

7
8 DATED this 28th day of May, 2004.

9 Respectfully submitted,

10 PRESTON GATES & ELLIS LLP

11
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EXHIBIT A

PwC's Analysis of the Impact of the Conversion on Premera's Rates Lacks Merit.

PricewaterhouseCoopers' analysis of the impact of the conversion on Premera's premium rates is invalid for three reasons.

First, PwC suggests that the only way Premera can increase its profitability is through increasing its premium rates. This is incorrect. Premera expects to improve its profitability through increased membership and continued improvements in administrative efficiency, facilitated by post-conversion access to capital. Increased membership will permit Premera to deliver superior customer service and competitively priced, innovative products.

Second, the PwC analysis makes several key assumptions. If any one of them is invalid, then the PwC analysis crumbles. As discussed below, three of four key assumptions are incorrect. Hence, the PwC analysis is equally wrong.

Third, the model on which the PwC analysis rests is worthless. The model is not predictive; it assumes what it sets out to show; and, by design, it fails to include any regulatory constraints. It truly reflects the precept, "garbage in, garbage out."

A. PwC's Claim that Premera Must Increase Premium Rates to Improve Profitability is Incorrect.

PwC's analysis assumes that the only way Premera can increase its profitability is through an increase in rates. RP 1956. PwC ignores the fact that Premera expects its post-conversion access to capital will permit Premera to increase membership and reduce per-member costs. These factors, in addition to delivering superior customer service and competitively priced, innovative products, will increase Premera's profitability.¹

Premera's projections for post-conversion membership are set forth in Exhibit E-7 to the Form A (Hearing Exhibit C-1). Membership for 2004 through 2006 is projected to grow approximately 4% per year for insured members and an average of 5% per year for

¹ Dr. Gold admitted that there were ways to achieve growth in operating income other than by raising rates—namely, "adding members" and "lowering costs." RP 2000.

1 administrative members. Premera expects to achieve this growth through delivery of
2 superior customer service and competitively priced, innovative products.

3 Premera's access to capital will materially assist it in creating and implementing
4 improvements in its administration and its infrastructure, which will lead to increased
5 membership. This in turn will permit Premera to spread its administrative costs over a
6 broader membership base. RP 119-21 (Barlow). Therefore, contrary to PwC's
7 assumption that Premera will have to increase rates to improve its profitability, Premera
8 will actually utilize its improved capital position to increase its membership, provide
9 innovative and competitively priced products to all its members, and thereby increase its
10 profitability.

11 **B. PwC's analysis relies on flawed assumptions.**

12 PwC suggests, in its "Economic Impact Analysis" reports and in the testimony of
13 Ms. Hunt, Mr. Staehlin and Dr. Gold, that rates could rise in Eastern Washington in
14 Premera's Individual and Small Group lines of business after the conversion. This
15 proposition relies on four assumptions, which Dr. Gold articulated at RP 1957:

16 The first assumption is that Premera's financial projections represent a
17 good baseline.

18 Second is that the conversion to for-profit from not-for-profit will increase
19 the pressure for Premera to achieve target margins.

20 Third, Premera has market power in the counties and lines of business in
21 which it has at least 65 percent market share.

22 And fourth, that regulatory requirements would not prevent premiums
23 from being raised.

24 Premera has no quarrel with the first assumption. It does note that PwC appears to
25 ignore the importance of membership projections, which are part of Premera's financial
projections. However, PwC's other three assumptions are all invalid. Accordingly,
PwC's conclusion arising from those assumptions—namely, that rates could go up in
Eastern Washington—is equally wrong.

1 **1. PwC's assumption regarding "increased pressure to achieve target**
2 **margins" is incorrect.**

3 PwC's assumption that the conversion will increase pressure on Premera to
4 achieve margins higher than those set forth in Premera's financial projections rests on a
5 number of premises, all of which are wrong.

6 First, contrary to PwC's position, shareholders do not just look at operating
7 margins. As Mr. Koplovitz from The Blackstone Group testified, investors focus on a
8 number of factors, including "transparency," "cash flow, rising returns, sector leadership
9 and high quality management." RP 1389. Mr. Kinkead, similarly, noted that investors are
10 concerned about growth in net income. RP 899-900.

11 When Ms. Hunt was cross-examined at the hearing, she admitted that net income
12 and growth prospects are important in assessing the performance of a company. RP 1700.
13 Yet, despite the advice of investment bankers and Ms. Hunt's own knowledge that such
14 factors were important to investors, PwC did not include net income or growth prospects
15 in its analysis. RP 1701. There is simply no evidence to support PwC's contention that
16 conversion will cause Premera to fixate on increasing its operating margins.

17 Second, PwC's assumption about increased pressure to achieve target margins is
18 based upon the unsupported and unsupportable statement in its Economic Impact Analysis
19 Report that public companies must meet net operating margin goals in all lines of
20 business. Ms. Hunt admitted on cross-examination that she was not aware of any public
21 companies that report results in their financial statements by line of business, or that report
22 target margins. RP 1700. Neither Ms. Hunt nor the other two PwC "economic impact"
23 consultants cited any other basis for their assumption. There is, therefore, no evidence to
24 suggest that Premera will abandon its strategy of viewing all of its lines of business as a
25 portfolio and of spreading risks over a number of different markets. *See* RP 1162-63.

 Third, the PwC reports present no evidence to support their assertion that
commercial non-profits behave differently from for-profit corporations. Ms. Hunt

1 admitted that she was not aware of any literature supporting such an assertion. RP 1717.
2 Indeed, substantial evidence contradicts that assertion. This includes peer-reviewed
3 studies about the behavior of for-profit health care companies (Exhibits P-3, P-26, and P-
4 28), as well as the evaluation by Milliman that conversion will likely have no impact on
5 Premera's premium rates. *See* Exhibit P-46 & RP 649-50 (Lusk); *see also* RP 547-48
6 (McCarthy).

7 Finally, the testimony at hearing belied PwC's assumption that the conversion will
8 increase pressure on Premera to achieve target margins. If Premera faces any additional
9 pressure from its shareholders, it will be to better serve its members. This was the
10 testimony of Mr. Barlow (RP 2477). It was also the testimony of Mr. Kinkead (RP 881-
11 82). And it was the testimony of Dr. McCarthy: "shareholders of for-profit companies
12 care very much that their company does a good job, that the quality is good and that prices
13 are good, because otherwise there will be no revenues." RP 628-29.

14 **2. PwC's assumption that Premera can exercise market power in the**
15 **counties and lines of business in which it has at least 65% market**
16 **share is incorrect.**

17 PwC's assumption that Premera can exercise market power in the Eastern
18 Washington counties in which it has at least a 65% market share is belied by the testimony
19 of the economists who actually studied the issue. Specifically, the notion that Premera
20 can exercise market power in the Individual and Small Group lines in Eastern Washington
21 was refuted by the OIC's economist, Dr. Leffler, who concluded that OIC rate regulation
22 constrains Premera's ability to exploit any market power which it might theoretically have
23 in those lines. RP 1769-70 & 1782. In other words, Dr. Leffler found that Premera does
24 not have any ability to raise premiums for Individual and Small Group products above
25 competitive levels in Eastern Washington.²

² No one has suggested that Premera has market power in Western Washington. Dr. Leffler concluded that Premera has no market power in Western Washington. RP 1762, 1779. In addition, PwC does not claim that Premera has market power in Eastern

1 Premera's economic consultant, Dr. McCarthy, came to the same ultimate
2 conclusion, further confirming that PwC's assumption is false. *See* Exhibits P-22, P-23,
3 and P-24; RP 548. Hence, there is no evidence to support PwC's assumption that Premera
4 can exercise market power, and there is substantial evidence showing such an assumption
5 to be wrong. And, of course, without having the ability to exercise market power,
6 Premera cannot increase rates.

7 **3. PwC's assumption that regulatory requirements would not prevent**
8 **premiums from being raised is incorrect.**

9 All of the actuaries who testified at the hearing agree that regulatory constraints,
10 specifically community rating and revenue neutrality requirements, prevent premiums
11 from being raised in Eastern Washington in the Individual and Small Group lines of
12 business for current members in regard to current products. This was the testimony of Ms.
13 Halvorson, RP 1004 & 1009-1010. It was the testimony of Ms. Lee, RP 2024-26. It was
14 even the testimony of Mr. Staehlin, RP 1872-74.

15 Ms. Halvorson demonstrated why an increase in premiums in Eastern Washington
16 would, because of community rating and revenue neutrality, result in a decrease in
17 premiums in Western Washington, leading to a revenue-neutral total premium.³ Ms. Lee
18 agreed. *See* ¶¶ 6-9 of Ms. Lee's Pre-filed Direct Testimony, Exhibit S-51, with which Ms.
19 Halvorson agreed. RP 1008-1013.

20 At the hearing, Mr. Staehlin raised the "possibility" that, in regard to potential new
21 members, Premera could introduce new plans that are dissimilar enough from current
22 plans to allow for actuarial judgment, which could possibly change rates as to those new
23 customers in Eastern Washington. RP 1874. In addition to being entirely speculative, the

24 Washington in any line of business other than Individual and Small Group. *See* Exhibit
25 S-20, p. 93 n.76.

³ Because medical costs are lower in Eastern Washington, premiums in the two parts of the state would actually move the opposite way if Premera ceased to price on a state-wide basis. *See* Exhibit P-82, p. 6; Exhibit S-51, ¶ 14; and Exhibit S-17, pp. 4, 40.

1 problem with PwC's argument is that there is no evidence as to whether such a scheme is
2 practical, would result in higher rates for those new customers, or would have any impact
3 on Premera's operating margins. Mr. Staehlin answered his own rhetorical question on
4 this issue: "Have I figured out how this could change rates in Eastern or Western
5 Washington? No." RP 1875. Dr. Gold echoed that rhetorical question in his testimony:
6 "Do I know if they can actually raise prices that far? No, actually I do not." RP 1961.

7 **C. PwC's model is of no value.**

8 Given the fact that three of PwC's key assumptions are incorrect, the
9 Commissioner does not even need to reach the question of the value, if any, of PwC's
10 model. Should the Commissioner wish to do so, however, the answer is clear: the model
11 is worthless.

12 First, Ms. Hunt, Dr. Gold, Mr. Cantilo, and even Mr. Odiorne admitted that the
13 model is not predictive. Rather, it simply calculates a result based on an assumption. RP
14 1731 (Hunt); RP 1992 (Gold); RP 2075 (Cantilo); RP 2437-38 (Odiorne).

15 Second, the model is based upon assumptions of market power and other factors
16 (RP 1957) that, as demonstrated above, are contrary to fact.

17 Third, and most astonishingly, PwC's model does not include any regulatory
18 constraints. RP 1992. Dr. Gold failed to include such constraints, even though his
19 predecessor, David Cooper, another PwC economist, warned that the failure to do so
20 would result in "garbage in, garbage out." RP 1992-93 & 1997-99; Exhibits P-155, P-
21 156.

22 PwC's "economic impact" analysis and ultimate assertion that Premera's
23 conversion will result in rate increases for the Small Group and Individual lines of
24 business in Eastern Washington are invalid. PwC's analysis is based on flawed
25 assumptions. It ignores market realities, the great weight of the evidence, and the

1 regulatory environment. Accordingly, PwC's "economic impact" analysis and resulting
2 conclusions should be discounted in their entirety.

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EXHIBIT B

Fears about Premera's Future as a For-Profit Entity Are Unfounded.

One of the more peculiar features of the hearing was the claim voiced by the OIC Staff that the Premera Board should have pursued a sale or a merger of the company rather than a conversion. Meanwhile, counsel for the intervenors (echoed in closing argument by counsel for the OIC Staff) suggested that a public company in the position of Premera would inevitably be acquired by a national carrier such as Anthem. The OIC Staff's criticism of the Board lacks any justification under the law or under the facts of this case. The intervenors' acquisition suggestion ignores key provisions of federal securities laws and Washington corporate and insurance law. Neither provides a basis for disapproving the proposed conversion.

As Sally Jewell testified, the Board's unanimous decision to pursue conversion followed an extensive due-diligence process that was as thorough as anything she has seen in her business career. RP 73-74. The Board considered a wide array of capital-raising options, including merger. RP 69-70, 72-73, 74-76. John Steel opined that this process more than satisfied the Board's obligations under Washington law. Ex. P-86, pp. 2-8; RP 2462. Patrick Cantilo said much the same thing in his communications with state officials. *See* Exhibits P-141, P-143. It appears, however, that the OIC Staff has ignored the standards of the Holding Company Acts, wandered into the Acquisition of Nonprofit Hospitals Act, assumed the mantle of the Department of Health, and misapplied one of the tests found in that statute.¹

¹ [T]he department [of health] may not approve an application unless . . .

* * *

(2) The nonprofit corporation that owns the hospital being acquired has exercised due diligence in authorizing the acquisition, selecting the acquiring person, and negotiating the terms and conditions of the acquisition[.]

RCW 70.45.070(2).

1 Premera's Board of Directors properly examined the alternatives and chose
2 conversion as the best way for Premera to raise the capital it needs to continue to be a
3 strong, independent insurer, delivering on its mission to provide peace of mind to its
4 members about their health care coverage. For this reason, even if there were a basis to
5 second-guess the Board's judgment, and there is none, the Board's choice would have to
6 be respected.²

7 The intervenors, for their part, claimed that Premera must be positioning itself to
8 be acquired, because most converted Blue plans have been absorbed by one or another
9 national corporations. The evidence does not support this claim. Premera has no plans to
10 be acquired, whether in the next five years or ten. RP 91 (Jewell). As the OIC Staff's
11 consultants have conceded, several nonprofit Blue Cross plans have found themselves
12 short of capital and been forced to seek an out-of-state rescuer. RP 1394 (Koplovitz),
13 2136-37 (Cantilo). Having a stronger capital base will make it substantially less likely
14 that Premera will meet a similar fate.

15 Commissioner Kreidler asked whether it would be easier for Premera to be
16 acquired by another entity after conversion to for-profit status and an IPO. The same
17 requirements under the Holding Company Acts that apply to Premera as a nonprofit
18 corporation would apply to the acquisition of a for-profit Premera, including whether the
19 acquisition is unfair and unreasonable to subscribers and not in the public interest. In
20 addition, the Form A documents and governing law create further protections against an
21 unwelcome or inappropriate acquisition of a for-profit Premera. And if these are thought
22 to be insufficient, the Commissioner can require reinstatement of anti-takeover provisions
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24 ² To assert (as the OIC Staff did in closing argument) that Premera does not need to
25 strengthen its capital base not only offends Washington law, which respects the business
judgments of boards of directors (*see Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)),
but also ignores the scope of regulatory review in a Form A proceeding. In addition, the
OIC Staff's assertion is completely contrary to the evidence, including the conclusions of
its own investment banking consultants. *See* RP 1361, 1385-87 (Koplovitz).

1 that Premera initially proposed but that were removed at the request of the OIC Staff's
2 consultants.

3 The OIC must review and approve any acquisition of Premera, whether Premera is
4 for-profit or nonprofit. The Insurance Commissioner's evaluation of such an acquisition
5 would focus upon the standards set forth in the Holding Company Act, for it establishes
6 the required content of a Form A, outlines the procedures by which a Form A is to be
7 examined and tested, and spells out the criteria for approval or disapproval of a Form A.
8 See RCW 48.31C.030(2), (4), and (5), respectively. Whether Premera is for-profit or
9 nonprofit at the time of a proposed acquisition, the OIC's approval of such an acquisition
10 would be based upon the same procedures and criteria.

11 Beyond these statutory and regulatory requirements, which apply to acquisitions of
12 nonprofit and for-profit insurers alike, there are additional requirements that would apply
13 to any attempted takeover of Premera after conversion. Under Washington law (RCW
14 23B.19.040), a person or entity that acquires 10 percent or more of Premera's stock cannot
15 acquire any greater control or engage in a further transaction such as a merger for a period
16 of five years without first obtaining the approval of Premera's Board. Article XII of New
17 PREMERA's Articles of Incorporation, set forth in Exhibit B-1 to the Amended Form A
18 (Hearing Exhibit C-2), makes specific reference to this anti-takeover provision.³

19 The testimony also established that a hostile bid for a for-profit Premera is a very
20 remote possibility. Brian Kinkead testified:

21 You alluded to the risk of a takeover. I think that's also a highly-remote
22 risk, because that implies that somebody would make an unfriendly or
23 hostile takeover attempt of the company. And that's—you just don't see
24 that, frankly, in the world of insurance generally. In the world of health
insurance, it is certainly not in the world of the Blue Cross/Blue Shield
Association for various reasons. The companies need regulatory approvals,

25 ³ Contrary to Mr. Cantilo's suggestion, the fact that other Blue plans enjoy an exception
from the ownership limitations in the BCBSA license agreement is wholly irrelevant. No
entity, including another Blue plan, can acquire more than 10% of Premera's stock as a
publicly traded company without being subject to RCW 23B.19.040.

1 hostile transactions historically have not been viewed favorably by
2 insurance commissioners.

3 Secondly, within the world of the Blue Cross/Blue Shield Association, it
4 would be an enormous risk, if a nonBlue company acquired this company it
5 would lose its license. But even if a Blue company tried to acquire it in a
6 hostile fashion, that company would likely be sanctioned by the Blue
7 Cross/Blue Shield Association.

8 RP 917-18. *Accord*, RP 2509 & 2511-12 (Barlow).

9 Any sale of Premera would require the approval of Premera's Board of Directors.
10 Directors of both nonprofit and for-profit corporations must look to the "best interest of
11 the corporation." *Compare* RCW Ch. 24.06.153(1) (nonprofit statute for PREMERA) *and*
12 RCW 24.03.127 (nonprofit statute for Premera Blue Cross) *with* RCW 23B.08.300(1)
13 (for-profit statute). In the context of a potential sale, "[g]enerally speaking, a board of
14 directors has no duty to negotiate with a party seeking to acquire a company, even when
15 that prospective bidder is offering to acquire the company at a substantial premium."
16 Exhibit P-86 at 6 n.13; *see* RP 2509-10 (Barlow).⁴

17 Moreover, shareholder approval is required for any merger or sale of substantially
18 all of the assets of a for-profit corporation. *See* RCW 23B.11.030, RCW 23B.12.020. For
19 purposes of such a decision, the Alaska Health Foundation and the Washington
20 Foundation each has a free vote under its respective Voting Trust and Divestiture
21 Agreement.

22 Finally, Premera's original Form A, filed in late 2002, included a Shareholder
23 Protection Rights Agreement. *See* Exhibit G-6 to Hearing Exhibit C-1. The Shareholder
24 Protection Rights Agreement contained "poison pill" provisions designed to restrict a
25 hostile acquisition of Premera, i.e., an acquisition without approval of Premera's Board of

⁴ If, on the other hand, a board decides to sell, it must abide by a standard of care that is higher than the normal business judgment rule. It "must conduct a thorough investigation of alternative dispositions in an effort to achieve maximum short-term value" Exhibit P-86 at 6 (citing *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1989); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1993)).

1 Directors. The Shareholder Protection Rights Agreement was eliminated in the Amended
2 Form A, because the OIC Staff's consultants specifically asked for its removal. *See*
3 Exhibit P-4, pp. 16-17; RP 1397 (Koplovitz). If, notwithstanding the points made above,
4 the Commissioner remains concerned about a post-conversion acquisition, Premera would
5 be amenable to reinstating the Shareholder Protection Rights Agreement that was part of
6 its original Form A and that was removed at the behest of the OIC Staff and its
7 consultants.

EXHIBIT C

RESPONSE TO OIC STAFF'S RECOMMENDED CONDITIONS

OIC Staff's Recommended Condition	Premera's Position
1. Approval by the Alaska Director of Insurance	The Commissioner's decision is to be based upon Washington law, and it is inappropriate to give the Alaska Director a veto over that decision. Absence of approval by the Alaska Director may affect Premera's ability to proceed, but it is not a basis to disapprove the transaction here.
2. Approval by the Oregon Insurance Commissioner	The Commissioner's decision is to be based upon Washington law, and it is inappropriate to give the Oregon Commissioner a veto over that decision. Absence of approval by the Oregon Commissioner may affect Premera's ability to proceed, but it is not a basis to disapprove the transaction here.
3. Approval by the Washington Attorney General	AG approval is not required unless there are charitable assets. That has not been established in this case and should not be presumed by the Commissioner.
4. Receipt of a fairness opinion from The Blackstone Group	Not required under the HCA. <i>Accord</i> RP 2442 (Odiome).
5. Receipt of an IPO procedures opinion from The Blackstone Group	No objection
6. Receipt of bring-down opinions just before the IPO that no material change has occurred in the facts and circumstances relating to the Form A	No objection
7. Receipt and approval of an application for a solicitation permit for selling shares in the IPO	No objection
8. Receipt and approval of an application for a solicitation permit for issuing shares under the proposed executive compensation plan	No objection. The IPO solicitation permit referred to in #7 above will include the maximum share reserve (7%) for the stock plan. "Executive compensation plan" is a misnomer; it's "equity compensation plan."
9. Receipt of a final opinion from Ernst & Young that the conversion transaction (a) will be treated as a series of tax-free transactions for federal income tax purposes, and (b) should not cause Premera to undergo a material ownership change under Section 382 of the Internal Revenue Code	No objection; already provided via Exhibits P-64 and P-220.

OIC Staff's Recommended Condition	Premera's Position
10. No adverse tax consequences arising from the possible loss of tax benefits under Section 833(b) would be passed on to policyholders	No objection, so long as limited to loss of Section 833(b) benefits resulting from the conversion.
11. Premera to abide by all of the terms of the assurances that the Commissioner accepts; failure to comply would be deemed a violation of the HCA	No objection, so long as limited to Premera's assurances contained in the Amended Form A.
12. Closing of the IPO to occur within twelve months of final approval by the Washington Attorney General, the Alaska Director of Insurance and the Oregon Insurance Commission, subject to extensions granted by the Commissioner upon application and for good cause	Mistakenly presumes AG approval is required. <i>See</i> Item 3 above. More importantly, it is inappropriate to eliminate the two three-month automatic extensions for pending litigation, as that creates a perverse incentive to sue to block the conversion.
13. Elimination of the requirement for the foundations to sell down to 80 percent in the first year after the IPO	This is a BCBSA requirement that cannot be eliminated. If a 20% public float is achieved through the IPO, the first-year ownership limitation of 80% will be automatically satisfied.
14. Elimination of the ten percent required sale contained in the Unallocated Shares Escrow Agent Agreement	No objection to eliminating 10% IPO requirement. <i>See also</i> proposed VTDA language in Exhibit D.
15. Elimination of Premera's right to veto all foundation nominations to the Premera Board (i.e., nominations for the Designated Member)	<i>See</i> proposed modified language in Exhibit D.
16. The foundation should retain the ability to have a Designated Member on Premera's Board until the foundation has less than five percent of the common stock outstanding of Premera, regardless of when that percentage level is reached	Expiration of the right to have a Designated Member at the earlier of 5 years or 5% ownership is a BCBSA requirement that cannot be eliminated.
17. The assurances contained in Exhibit E-8 to the Form A or provided through testimony should be included as conditions in the Commissioner's order approving the conversion	No objection, so long as "testimony" here refers to the Pre-Filed Direct Testimony of Kent Marquardt and Exhibit A thereto (Exhibits P-58 and P-59, respectively).
18. Each foundation must have a separate divestiture schedule	Consistent with BCBSA requirements, the schedules must, in the aggregate, meet the BCBSA divestiture guidelines. <i>See</i> proposed VTDA language in Exhibit D.

OIC Staff's Recommended Condition	Premera's Position
19. Each foundation must have a separate 5% free vote	The BCBSA requires that there be no more than one 5% (- 1 share) bloc outside the voting trust. This BCBSA requirement cannot be eliminated.
20. The voting trust agreement must terminate upon the loss of the Blue license or a change in the Association rules	Survival of the voting trust is important to Premera, to its subscribers, and to the value of its stock. <i>See</i> proposed modified language in Exhibit D.
21. The foundation must be allowed to vote freely on any change-in-control proposal that involves 20% or more of Premera's outstanding stock	The BCBSA requires that the change-in-control threshold for a free vote be 50.1%, as approved in the WellChoice conversion. This BCBSA requirement cannot be changed.

EXHIBIT D

- Amendment to New PREMERA By-Laws, Article II, Section 4(f), Independent Directors
- Amendments to Voting Trust and Divestiture Agreement:
 - Section 5.03, Nomination of Directors
 - Section 7.08, Divestiture Allocation
 - Section 10.01, Term and Termination

Section 4 Independent Directors. A majority of the Board of Directors shall also be “Independent Directors” as such term is defined below. To qualify as an “**Independent Director**,” the members of the Board of Directors must affirmatively determine that the director has no material relationship with the Corporation (either directly or as a partner, shareholder or officer of an organization that has a relationship with the Corporation). In addition to the determination above, members of the Board of Directors shall be considered “Independent Directors” if they are not, or have not been, engaged in any of the following relationships:

(a) A director who is or has been an employee or executive officer of the Corporation or the Blue Cross and Blue Shield Association or any of its affiliates, at any time during the past five (5) years.

(b) A director who is, or at any time during the past five (5) years has been, affiliated with or employed by a present or former auditor of the Corporation or any of its affiliates.

(c) A director who currently is employed, or at any time during any of the past three (3) years was employed, as an executive of another company where any of the Corporation’s present executives serves on that company’s compensation committee.

(d) A director who is an “affiliate” (as defined below) of the Corporation or any subsidiary.

(e) A director who receives, or has at any time during the past five (5) years received, more than \$100,000 per year in direct compensation from the Corporation, other than director and committee fees, pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), compensation for service as a former CEO or chairman or compensation received by an immediate family member for service as an employee of the Corporation at a level below executive officer.

(f) A director who is currently employed as an executive officer or an employee, or whose immediate family member is an executive officer, of another company ~~(A) that accounts for at least two (2) percent or \$1 million, whichever is greater, of the Corporation’s consolidated gross revenues, or (B) for which the Corporation accounts for at least two (2) percent or \$1 million, whichever is greater~~that makes payments to, or receives payments from, the Corporation for property or services in an amount which, in any single fiscal year, exceeds the greater of \$1 million, or 2% of such other company’s consolidated gross revenues or exceeds the lesser of \$10 million or 2% of the Corporation’s consolidated gross revenues (until three years after falling below such applicable threshold).

ARTICLE V

STANDSTILL

Section 5.03. Nomination of Directors. (a) Subject to Section 5.03(b) below, the Beneficiary shall not itself, nor shall it initiate, suggest or otherwise encourage the Board of Directors or any other Person to, (i) nominate any individual as a candidate for election to the Board of Directors, or (ii) appoint any individual to fill any vacancy on the Board of Directors. The Beneficiary shall not support, endorse or otherwise encourage the election of any candidate for election to the Board of Directors other than a candidate or candidates nominated by an Independent Board Majority except as set forth in Section 5.03(b) below.

(b)(i) Notwithstanding the foregoing, for so long as the Beneficiary Beneficially Owns 5% or more of the issued and outstanding Capital Stock, but in no event for a period of time longer than five (5) years from the date hereof, the Beneficiary ~~and the Alaska Health Foundation (so long as the Alaska Health Foundation Beneficially Owns 5% or more of the issued and outstanding Capital Stock) will jointly~~will have the right to propose a slate of three (3) individuals from which the Governance and Nominating Committee of the Board of Directors will nominate one (1) such individual for election by the shareholders to serve as a member of the Board of Directors (the "Designated Member"). ~~If~~ The proposed candidates will be reviewed by the Governance and Nominating Committee of the Board of Directors pursuant to the process of review applicable to Director candidates generally. If after a good faith review consistent with the process applicable to candidates generally, none of such proposed individuals (or any additional proposed individuals) are reasonably acceptable to the ~~Board of Directors for election~~Governance and Nominating Committee for nomination to the Board of Directors, the ~~Board of Directors~~Governance and Nominating Committee will promptly notify the Beneficiary ~~and the Alaska Health Foundation (if applicable)~~ of such determination, and at the Beneficiary's request shall consult with the Beneficiary concerning the factors involved in such determination, and the Beneficiary ~~and the Alaska Health Foundation (if applicable)~~ will jointly propose one or more additional individuals from which the ~~Board of Directors~~Governance and Nominating Committee will choose. Each of the individuals proposed by the Beneficiary ~~and the Alaska Health Foundation (if applicable)~~ must (i) qualify as an Independent Director, (ii) have experience with public companies as either a board member, an executive officer, or a partner/managing director at a nationally-recognized: (A) accounting firm registered with the Public Company Accounting Oversight Board, (B) investment banking firm or (C) strategic management consulting firm, (iii) not hold an elective or appointive full-time governmental office or be an employee of any governmental body or agency or have held such office in the states of Washington or Alaska or have been so employed in the states of Washington or Alaska for the prior three (3) years and (iv) acknowledge in writing that notwithstanding his or her designation by the Beneficiary, he or she owes fiduciary duties to all stockholders to the same extent as the other members of the Board of Directors. For so long as the Beneficiary has the rights set forth in the first sentence of this Section 5.03(b)(i), the Designated Member shall be submitted to the stockholders of the Company for election in the manner by which a Qualified Candidate (as defined in the Bylaws of the Company) is

submitted ~~to the stockholders for election~~ by the Independent Board Majority. to the stockholders for election. The Designated Member shall be a Class II director whose term shall expire in two years. The Designated Member shall have the rights regarding positions on the Board of Directors and on committees of the Board of Directors as set forth in Articles II and III of the Bylaws. For so long as the Beneficiary has the rights set forth in the first sentence of this Section 5.03(b)(i), in the event the Designated Member resigns before the end of his or her term and at the end of the Designated Member's term, the Beneficiary ~~and the Alaska Health Foundation (if applicable)~~ shall be entitled to jointly propose a new Designated Member in accordance with the procedures established by this Section 5.03(b)(i). In the event that this Agreement is terminated pursuant to Section 10.01 hereunder, the Designated Member nominated and elected pursuant to this Section 5.03(b)(i) shall continue to serve on the Board of Directors until the end of his or her term.

Section 7.08. Divestiture Allocation. For purposes of Section 7.01(b), Section 7.02, Section 7.03, and Section 7.04 and Section 7.07 hereof and for so long as both the Beneficiary and the Alaska Health Foundation Beneficially Own shares of Capital Stock, the allocation of compliance with the divestiture thresholds and the allocation of any Delinquent Shares, in each case between the Beneficiary and the Alaska Health Foundation, shall be based on the initial pro-rata allocation of the shares of in such sections shall be considered on a combined basis such that the Capital Stock (other than Class B Common Stock) between Beneficially Owned by both the Beneficiary and the Alaska Health Foundation shall be considered in the aggregate. Notwithstanding the foregoing, the determination of any Delinquent Shares shall be considered on a pro-rata basis as described in the following paragraphs of this Section 7.08, unless an alternate allocation of the aggregate divestiture thresholds is agreed to in writing by the Beneficiary and the Alaska Health Foundation.

For purposes of applying Section 7.07, in the event at any Divestiture Deadline, as such may be extended pursuant to Sections 7.05 and/or 7.06, the aggregate Beneficially Owned Common Stock of the Beneficiary and the Alaska Health Foundation exceeds the maximum combined Beneficially Owned permissible percentage of the issued and outstanding shares of each class of Capital Stock applicable at such Divestiture Deadline, the Beneficiary and the Alaska Health Foundation shall be considered separately as provided in this Section 7.08. The analysis shall be based on the initial percentages of the shares of Capital Stock issued to the Beneficiary and the Alaska Health Foundation, respectively, on closing of the Conversion Transaction and outstanding immediately prior to the IPO (each respective percentage allocation, herein an "Agreed Allocation Percentage"). To establish whether and to what extent the Beneficiary is in possession of Delinquent Shares, the Beneficiary's Agreed Allocation Percentage shall be multiplied by the aggregate permissible percentages in Sections 7.01 through 7.04 to yield its "Pro Rata Allocation." The Beneficiary shall not be deemed to hold or be required to sell Delinquent Shares if the Beneficiary's Beneficial Ownership of the issued and outstanding Capital Stock is less than its Pro Rata Allocation, regardless of the Alaska Health Foundation's Beneficial Ownership of shares of Capital Stock. An illustration of the application of this Pro Rata Allocation is as follows: assume the respective Agreed Allocation Percentages for purposes of this illustration only are Beneficiary 80% and the Alaska Health Foundation 20%, and the relevant Divestiture Deadline is the Third Anniversary pursuant to Section 7.02; if in the aggregate the Beneficiary and Alaska Health Foundation are the Beneficial Owners of more than 50% of the issued and outstanding Capital Stock, but the Beneficiary is the Beneficial Owner of less than its Pro Rata Allocation of 40% of the issued and outstanding Capital Stock (i.e., the Beneficiary's Agreed Allocation Percentage (80%) multiplied by the maximum aggregate percentage at the Three Year Divestiture Deadline, which is 50% of the issued and outstanding Capital Stock), the Beneficiary would have no Delinquent Shares and provisions of Section 7.07 would not apply to the Beneficiary. If, conversely, the Beneficiary in this illustration were the Beneficial Owner of more than its Pro Rata Allocation of 40% of the issued and outstanding Capital Stock, the Beneficiary would have Delinquent Shares to the extent that its ownership exceeds the Pro Rata Allocation, and the provisions of Section 7.07 would apply.

If there are no Agreed Allocation Percentages, then a notional allocation shall be used in place of the Agreed Allocation Percentages for purposes of this Section 7.08 until the allocation between the Beneficiary and the Alaska Health Foundation is resolved. The notional allocation shall reflect the respective percentages obtained by taking the number of shares of Capital Stock Beneficially Owned by the Beneficiary outside the Unallocated Shares Escrow Agent Agreement, the number of shares of Capital Stock Beneficially Owned by the Alaska Health Foundation outside the Unallocated Shares Escrow Agent Agreement, and the number of shares of Capital Stock subject to the Unallocated Shares Escrow Agent Agreement, and dividing each such number by the total number of the initial issued and outstanding shares of Capital Stock prior to the IPO. For purposes of the aggregate Divestiture Deadline percentage limits, the shares held by the Unallocated Shares Escrow Agent shall be combined with the shares Beneficially Owned by the Beneficiary and the Alaska Health Foundation and held outside of such Unallocated Shares Escrow. An illustration of the application of this notional allocation is as follows: assume for purposes of this illustration that the Beneficiary and the Alaska Health Foundation are unable to agree on ownership of 20% of the initial issued and outstanding Capital Stock and, as a result, the Beneficiary is the Beneficial Owner of 70% and the Alaska Health Foundation is the Beneficial Owner of 10% respectively of the issued and outstanding Capital Stock held outside of the Unallocated Shares Escrow; assume the relevant Divestiture Deadline is the First Anniversary pursuant to Section 7.01(b), if in the aggregate the shares Beneficially Owned by the Beneficiary and by the Alaska Health Foundation together with the shares held under the Unallocated Share Escrow Agent Agreement are more than 80% of the issued and outstanding Capital Stock, but the Beneficiary is the Beneficial Owner of, and holds outside of the Unallocated Share Escrow, less than its notional percentage (70%) multiplied by the maximum aggregate percentage at the First Anniversary (80%) or 56% of the total issued and outstanding Capital Stock at that time, the Beneficiary would have no Delinquent Shares and the provisions of Section 7.07 would not apply to the Beneficiary.

In the event the Beneficiary and the Alaska Health Foundation agree in writing (and so notify the Company) to an alternate allocation of the aggregate divestiture thresholds or reach such agreement after shares are placed in the Unallocated Shares Escrow Agent Agreement, such agreed allocation upon receipt of approval by the Company shall be treated as the Agreed Allocation Percentage for purposes of application of this Section 7.08 and Section 7.07.

ARTICLE X

TERMINATION

Section 10.01. Term and Termination. This Agreement shall terminate upon the earlier of (i) joint written notice by the Beneficiary and the Company to the Trustee that the Beneficiary ~~and the Alaska Health Foundation together Beneficially Own~~**Owns** less than five percent (5%) of the issued and outstanding shares of Common Stock and less than five percent (5%) of the issued and outstanding shares of every other class of Capital Stock; or (ii) the tenth (10th) anniversary hereof; *provided, however*, that at any time before such expiration date (or before the expiration date after an extension in accordance herewith) the Beneficiary and the Company, together with the written consent of the Trustee, may extend the term of this Agreement for an additional period of not more than ten years from the date of the extension agreement. Otherwise, the Voting Trust is hereby expressly declared to be and shall be irrevocable; and provided further, that if at any time the Company's current license agreement (without giving effect to changes thereto after the date hereof) with respect to the Marks is permanently terminated by the BCBSA (it being understood that the transfer of such license to the Company by PREMERA shall not constitute such a termination), with no further right to cure or appeal, as a result of the Company's breach of its obligations thereunder, so long as such breach was not due to any act or omission of the Beneficiary, then by written notice to the Company and the Trustee, the Beneficiary may elect to (x) terminate the provisions of Article VII and Section 5.02 hereof, and disregard the references in Section 3.02 and 5.05 to "Ownership Limit" and the references in Section 5.06 to "Basic Protections"; and (y) at such time as the Beneficiary together with the Alaska Foundation shall Beneficially Own less than 20% of the Company's Capital Stock, terminate the provisions of Articles IV and V hereof, other than Sections 4.03(a), 4.03(b) and 5.03.